job and would not hesitate to surrender it, if either business or politics should interfere with the independent exercise of their duties for the best advantage of the country as a whole.

If that is to be achieved, and the future of the Federal Reserve System is to be assured, the people themselves must take a hand. They must never fail to rally to the support of these faithful servants when unfairly attacked, and they must not lose any opportunity of showing them that their services are appreciated. If the people do not prove that they honor their leaders and stand by them loyally, what incentive is there for these leaders to hold out?

In a similar manner, Congress must feel that whoever dares to encroach upon the independence of the Federal Reserve System attacks the most sacred treasure of the people. In Washington I came to know many upright men of the very highest type; nevertheless a large number of our political leaders might prefer that the Federal Reserve System be subservient rather than independent. They want open doors for patronage and a ready compliance with the wishes of their constituents.

Protection for the Federal Reserve System must, therefore, not be expected from Washington, unless it is possible to arouse and strengthen the small number of distinguished men in the Administration, and in Congress, who would understand the danger and would fight to ward it off. They will win if the country makes Congress understand that its heart is in it. If the people cease to exercise vigilance, if ever they relax in their insistence upon the integrity of their banking system, it may develop, as it did before, from the greatest blessing into the gravest menace. A Federal Reserve System turned into a political octopus, a national Tammany Hall, would infest not only the counting houses but every farm and hovel in the country.

Early Functioning of the Federal Reserve System

By ARTHUR REYNOLDS
President, Continental and Commercial National Bank of Chicago

ON October 26, 1914, the Secretary of the Treasury sent a message to the twelve Federal Reserve Banks, then organizing, instructing them to begin definite operations on November 16, 1914. Great haste was made to secure adequate quarters and a working staff. One-sixth of the capital stock subscriptions were called on November 2, 1914, and on the sixteenth of November the Banks formally opened for business.

"Regulation in ordinary times, as well as protection in extraordinary times" was the principle laid down by the Federal Reserve Board in its first report after two months of operation, for defining the general scope of activities of the Federal Reserve Banks. There being no extraordinary times to call for the protective function as set forth in the above definition of policy, the operation of the Federal Reserve System during the first two years was confined largely to efforts, first, to "unify the banking system of the country" by seeking new members among the ranks of the state banks; second, to endeavor to regulate interest rates and equalize the demand for

money by the purchase of bills and acceptances in the open market, and third, to establish a par collection system and the clearance of all checks on member banks.

The men charged with the operation of the Federal Reserve System, upon its inception, promptly sought to induce the banks of the country to make full use of its facilities. They were influenced, undoubtedly, by the feeling on their part that it was necessary to keep employed such funds as were entrusted to them in order to pay expenses and to earn dividends upon the capital stock. They felt that member banks should rediscount with the Reserve Banks, and by one means and another endeavored to accomplish this. But in the early history of the System it was destined to meet with no such ready response. The old banking practice of the country had its basis in too many years of actual habit, and it was but natural that banks generally should be hesitant and cautious in making radical changes in their methods; indeed, a great many of them felt that the Federal Reserve Banks, if supported too generously, would ultimately encroach upon and usurp some of the functions of existing banks. They were loath, therefore, to go farther than the mere subscription of capital. It was inevitable that a great many bankers in the country should look upon the System as a government undertaking and fear that transactions with it would be involved in "red tape." They feared also that it would be influenced by politics.

Prejudice Against Rediscounting

Coincident with this, and one of the greatest difficulties in the way of those who were ambitious for the quick acceptance of the System, was the long-time prejudice of bankers against disclosing their borrowings to the public. They had been educated to believe that deposits were the indication of strength, and that borrowed money was a sign of weakness. Any rediscounts or bills payable which they might lodge with the Federal Reserve Banks would appear in their statements, and since, in many instances, they could obtain credit from their city correspondents through methods which did not involve the direct obligation of their banks, and, therefore, did not appear as borrowed money, they were quite content to utilize the credit facilities of those city correspondents. It must be remembered that at this time there were no unusual conditions confronting the country; rates were low and money was easily obtainable. Bankers outside of reserve centers had, over a considerable period of years, built up their relationships with reserve city and central reserve city correspondents. Those who had occasion to borrow for seasonal requirements were intimately acquainted with the city banks which had met their needs. Those banks which had for many years maintained balances with other banks felt that they had a cumulative asset of which they could avail themselves should the occasion arise. There was mutual understanding between correspondents, while the Reserve System was an untried departure.

It will also be remembered that the Federal Reserve Act did not make provision for the turning of all reserve funds over to the Reserve Banks. The change was gradual. Old relations between banks were, therefore, not interrupted.

All of these things militated against the fullest possible functioning of the System in its early stages, and such rediscounts and bills payable as were lodged with the Federal Reserve Banks were largely in the nature of "courtesy transactions" on the part of friendly

bankers who wished to help educate the banking fraternity to use the Federal Reserve facilities.

"Courtesy Transactions"

Comment by the Ninth District Reserve Bank in its report for the year 1915 is illustrative of the general condition confronting all of the Reserve Banks at that time:

> During the latter half of November and the month of December, 1914, such rediscounts as were afforded members were largely courtesy transactions, the greater part representing the efforts of larger banks to acquaint the public with the new Federal Reserve currency. After January 1, 1915 . . . loans dropped to the lowest ebb in many years. Rates on commercial paper took new low levels. . . .

The one great plaint during this time was the non-payment of interest upon balances carried at the Reserve Banks. In the report containing the preceding comment of the Minneapolis bank, Pierre Jay, Federal Reserve agent at New York City, said:

> . . . it is among the country banks as a class that most of the apathy and hostility to the Federal Reserve System which still persists is found. Their opportunities and earnings are relatively small and they must figure closely to live. They feel the loss of interest on reserve deposits; the absence, as yet, of dividends on their capital contributions, and the prospective loss or decrease of the exchange they generally charge on remitting for checks drawn upon them.

The institution of the par collection system met with great disapproval from many banks in the smaller communities where the earnings derived from exchange charges had for many years constituted a comparatively substantial part of the total earnings. Some banks sought to surrender their national bank charters and incorporate as state banks. This was only the forerunner of the more serious opposition encountered when the Reserve Banks undertook to make it compulsory upon all banks to accept their own items at par.

The State Bank Problem

The early attempts to obtain new members from the ranks of the state banks were bitterly opposed in many quarters. Legislation was even resorted to in combating the advances of representatives of the Federal Reserve Banks in this direction. In its second annual report on December 31, 1915, the Federal Reserve Board observed:

> It is an unfortunate fact that, in some of the states, reserve requirements for state banks and trust companies have been materially lowered by legislative enactment since the adoption of the Federal Reserve Act. . . . This is an element of danger in our banking system, because the weakening of the reserves of the state banks and trust companies makes them more vulnerable in times of emergency. . . . It would be deplorable were feelings of state or local pride to lead any of the states into competition with the Federal Reserve System such as would prompt them to lower their own banking standards or reserve requirements with a view of enabling or inducing state banks to refrain from taking membership therein. The Board is satisfied that state banks gain in safety and that states sacrifice none of their prerogatives or powers when such banks become members of the Federal Reserve System, and therefore, expresses the hope that no seeming divergence of interest will be permitted to impede the establishment of higher standards of banking.

Every means was employed to make memberships in the System attractive to state banks and later amendments to the law aided in inducing them to join.

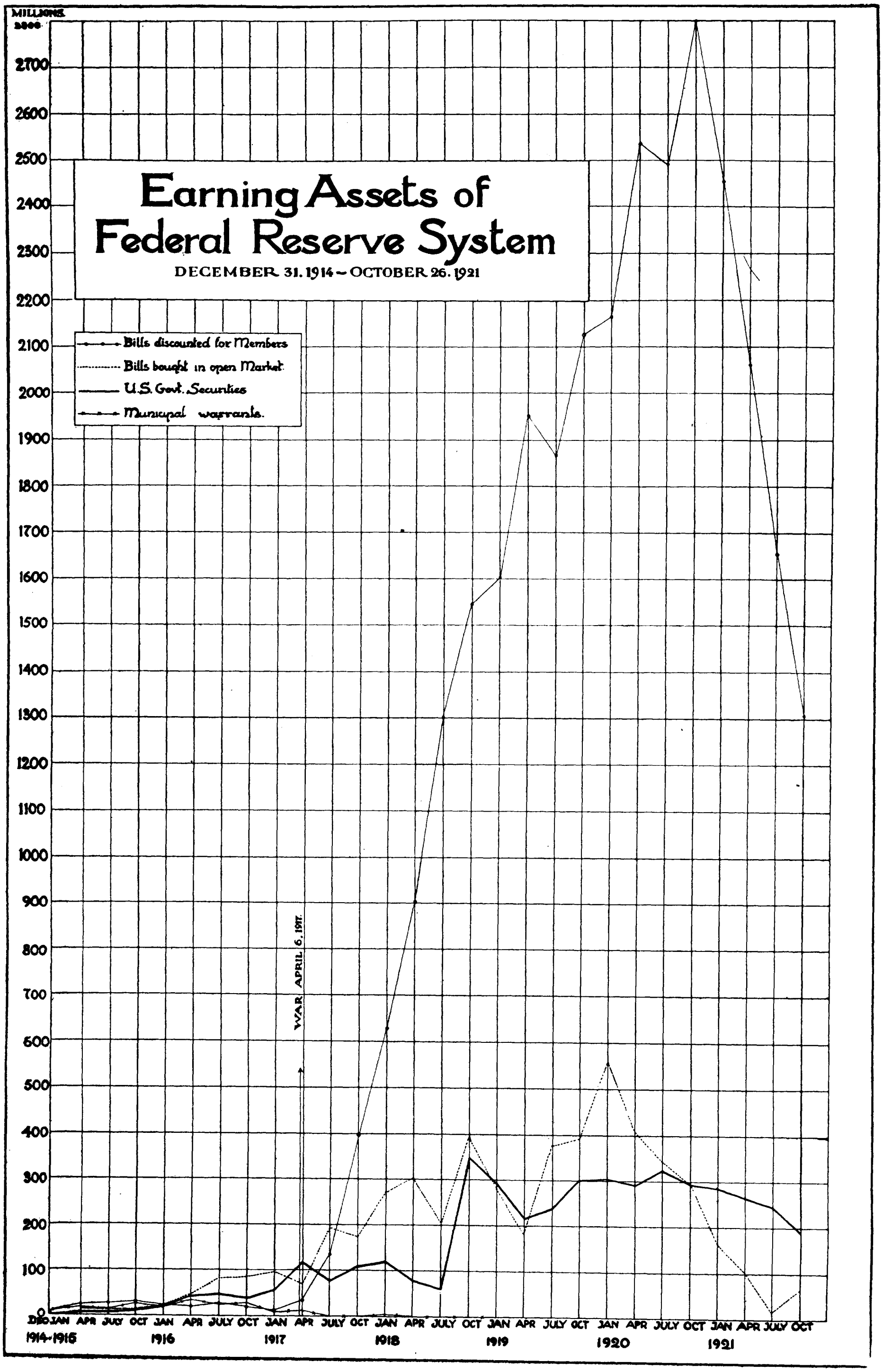
Earning Assets Before and After the War

Failure to secure applications for rediscounts to employ more than a

small part of the funds of the System, caused the Reserve Banks to invest in government bonds, acceptances and municipal warrants. A careful study of the graph on page 78 showing the curves of the earning assets of all of the Reserve Banks combined, from the date of opening to January 1st, 1921, gives a concrete picture of the early functioning of the System in contrast to its operations after the United States entered the War.

EARNING ASSETS OF THE FEDERAL RESERVE SYSTEM
DECEMBER 31, 1914–OCTOBER 26, 1921

Date	Bills discounted for members	Bills bought in open market	U. S. government securities	Municipal warrants
1914				
December 31	9,909,000	....	205,000	734,000
1915				
January 29	13,955,000	....	2,015,000	11,165,000
April 30	22,774,000	13,812,000	6,813,000	18,656,000
July 30	29,102,000	11,625,000	7,923,000	16,107,000
October 29	30,448,000	13,619,000	10,505,000	25,014,000
1916				
January 28	26,901,000	26,314,000	21,372,000	20,602,000
April 28	21,448,000	47,585,000	45,841,000	36,933,000
July 28	27,594,000	83,454,000	48,656,000	27,220,000
October 27	21,131,000	86,085,000	40,469,000	29,890,000
1917				
January 26	15,711,000	97,697,000	55,769,000	12,249,000
April 27	35,043,000	71,400,000	117,818,000	14,999,000
July 27	138,459,000	195,097,000	76,953,000	1,469,000
October 26	397,094,000	177,590,000	110,042,000	233,000
1918				
January 25	627,632,000	273,912,000	123,194,000	4,902,000
April 26	901,743,000	302,844,000	78,853,000	2,722,000
July 26	1,302,151,000	205,274,000	57,012,000	103,000
October 25	1,546,164,000	398,623,000	350,311,000	24,000
1919				
January 31	1,601,128,000	281,293,000	294,784,000	4,000
April 25	1,950,412,000	185,822,000	218,636,000	....
July 25	1,867,602,000	375,556,000	239,400,000	....
October 31	2,128,547,000	394,355,000	301,254,000	....
1920				
January 30	2,174,357,000	561,313,000	303,521,000	....
April 30	2,535,071,000	407,247,000	293,514,000	....
July 30	2,491,630,000	345,305,000	325,380,000	....
October 29	2,801,297,000	298,375,000	296,371,000	....
1921				
January 28	2,456,475,000	165,058,000	287,320,000	....
April 27	2,063,739,000	103,609,000	267,792,000	....
July 27	1,650,496,000	19,424,000	249,488,000	....
October 26	1,308,749,000	62,326,000	190,946,000	....


Earning Assets of Federal Reserve System
DECEMBER 31. 1914 – OCTOBER 26. 1921
Bills discounted for Members
Bills bought in open Market.
U.S. Govt. Securities
Municipal warrants.
MILLIONS
2700
2600
2500
2400
2300
2200
2100
2000
1900
1800
1700
1600
1500
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
WAR APRIL 6, 1917.
DEC JAN APR JULY OCT JAN APR JULY OCT JAN APR JULY OCT JAN APR JULY OCT JAN APR JULY OCT JAN APR JULY OCT JAN APR JULY OCT
1914-1915
1916
1917
1918
1919
1920
1921

The chart of the earning assets of the System demonstrates clearly that once the exigencies of the war period arose, there was no hesitancy upon the part of member banks to make heavy demands upon the facilities of the reserve banks. Indeed, as the momentum gained force, many bankers in their eager rush to meet the requirements of their customers lost sight of the earlier scruples concerning borrowed money and the pendulum swung to the other extreme. Instead of seeking rediscounts the officials of the System found themselves striving to conserve the financial resources of the country.

The general impression prevails that the War caused a development of the Federal Reserve Banks during the seven years of their operation that probably would not have occurred in many times that number of years under other circumstances. Study of the early functioning of the System bears out that assumption. The early operations of the banks also call to mind the point that they were less far-reaching in their influence. Business getting efforts are forgot or nearly forgot. But what was, may, perhaps, merely presage what is to come. Under stable conditions, the Reserve Banks may make smaller profits, but they will not serve a less useful purpose. Commercial banking must respond to and reflect the activities of business. In times of great activity, whether seasonal or cyclical, the Reserve Banks will be called upon to meet a corresponding demand. In the usual process of business they will have recourse to open-market operations. Through these operations they may exert a great and important influence on the commercial banks, on interest rates and on business activity.

The Federal Reserve System, State Banks and Par Collections

By PIERRE JAY

Chairman and Federal Reserve Agent, Federal Reserve Bank of New York

FULL accomplishment of the purpose of the Federal Reserve Act, to provide a means whereby the strength and resources of the numerous independent banks of the United States would be made effective for concerted or coöperative action for the protection of the banking system and the service of the nation's commerce, industry and agriculture, depended upon membership of a very considerable proportion of the banks of the country. The provision of the Act making membership compulsory for national banks, brought at once into the System about 7,600 national banks with capital and surplus of $1,788,000,000 and total resources of $11,492,000,000, thus giving a membership at the outset comprising 42.6 per cent of the total banking resources of the country. But the provision for the admission of state institutions was merely to the effect that they might, upon application, be permitted to become members, subject to regulations of the Federal Reserve Board, and should then have the rights and privileges of other member banks.

STATE INSTITUTIONS SLOW TO JOIN

Contrary to general expectation, the problem of state bank membership was found complicated. Most of the state